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S E C R E T.

COPY NO.

C A B I N E T 36 (39)

A Special Meeting of the Cabinet will be held in the
Prime Minister's Room in the House of Commons on
WEDNESDAY, 5th JULY, at 5.30 p.m.

AGENDUM.

THE FINANCIAL SITUATION.

(Reference Cabinet 29 (39) Conclusion 3)

A Memorandum by the Chancellor of the Exchequer covering
a report by the Treasury on the German Financial Effort
for Rearmament (C.P. 148 (39)) - to be circulated this
evening.

A Memorandum on the Financial Position (C.P. 149 (39))
will be circulated tomorrow evening.

(Signed) E.E. BRIDGES

Secretary to the Cabinet.

Richmond Terrace, S.W.1.

3rd July, 1939.

SECRET.COPY NO. 2.C A B I N E T 36 (39)

CONCLUSIONS of a Meeting of the Cabinet held
in the Prime Minister's Room, House of Commons,
on WEDNESDAY, 5th July, 1939 at 5.30 p.m.

P R E S E N T.

The Right Hon. Neville Chamberlain, M.P.,
Prime Minister. (In the Chair).

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| <p>The Right Hon.
Sir John Simon, G.C.S.I., G.C.V.O.,
O.B.E., K.C., M.P., Chancellor
of the Exchequer.</p> | <p>The Right Hon.
Viscount Runciman,
Lord President of the
Council.</p> |
| <p>The Right Hon.
Lord Maugham,
Lord Chancellor.</p> | <p>The Right Hon.
Sir Samuel Hoare, Bt., G.C.S.I.,
G.B.E., C.M.G., M.P., Secretary
of State for Home Affairs.</p> |
| <p>The Right Hon.
Viscount Halifax, K.G., G.C.S.I.,
G.C.I.E., Secretary of State for
Foreign Affairs.</p> | <p>The Right Hon.
Sir John Anderson, G.C.B.,
G.C.S.I., G.C.I.E., M.P.,
Lord Privy Seal.</p> |
| <p>The Right Hon.
Sir Thomas Inskip, O.B.E., K.C.,
M.P., Secretary of State for
Dominion Affairs.</p> | <p>The Most Hon.
The Marquess of Zetland, G.C.S.I.,
G.C.I.E., Secretary of State
for India and Burma.</p> |
| <p>The Right Hon.
Malcolm MacDonald, M.P.,
Secretary of State for the
Colonies.</p> | <p>Admiral of the Fleet the Right Hon.
Lord Chatfield, G.C.B., O.M.,
K.C.M.G., G.V.O., Minister
for Co-ordination of Defence.</p> |
| <p>The Right Hon.
W.S. Morrison, M.C., K.C., M.P.,
Chancellor of the Duchy of
Lancaster.</p> | <p>The Right Hon.
The Earl Stanhope, K.G.,
D.S.O., M.C., First Lord of
the Admiralty.</p> |
| <p>The Right Hon.
L. Hore-Belisha, M.P.,
Secretary of State for War.</p> | <p>The Right Hon.
Sir Kingsley Wood, M.P.,
Secretary of State for Air.</p> |
| <p>The Right Hon.
John Colville, M.P., Secretary
of State for Scotland.</p> | <p>The Right Hon.
Oliver Stanley, M.C., M.P.,
President of the Board of Trade.</p> |
| <p>The Right Hon.
The Earl De La Warr, President
of the Board of Education.</p> | <p>The Right Hon.
Walter Elliot, M.C., M.P.,
Minister of Health.</p> |
| <p>The Right Hon.
Ernest Brown, M.C., M.P.,
Minister of Labour.</p> | <p>The Right Hon.
E.L. Burgin, M.P.,
Minister without Portfolio.</p> |

THE FOLLOWING WERE ALSO PRESENT:-

Sir Richard V.N. Hopkins, K.C.B.,
Second Secretary,
H.M. Treasury.
Sir Edward Bridges, K.C.B., M.C., Secretary.

C A B I N E T 36 (39).

CONCLUSIONS of a Meeting of the Cabinet held on
WEDNESDAY, 5th JULY, 1939, at 5.30 p.m.

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DEFENCE
REGULATIONS.

(Previous
Reference:
Cabinet 28 (39)
Conclusion 8)

FR. 39) 39 / 13.

1. THE PRIME MINISTER recalled the decision of the Cabinet, reached at the Meeting referred to in the margin, as regards the date at which the Defence Regulations should be put into force. He said that there was some doubt as to the Regulations which should be introduced as soon as an emergency occurred and that it was important that this matter should be cleared up as quickly as possible.

The Prime Minister accordingly proposed, and the Cabinet agreed, that a Cabinet Committee should be set up, composed as follows:-

The Home Secretary (Chairman),
The Lord Privy Seal,
The First Lord of the Admiralty,
The Secretary of State for War,
The Secretary of State for Air,
The President of the Board of Trade,
The Minister of Supply-Designate.

The Prime Minister thought that later on certain questions would arise as to the form of the Regulations, on which the advice of the Lord Chancellor would be of great assistance, but he did not think that it was necessary that the Lord Chancellor should be troubled with the matters that would fall to be discussed by the proposed Cabinet Committee.

THE FINANCIAL
SITUATION.

(Previous
Reference:
Cabinet 29 (39)
Conclusion 3)

2. The Cabinet had before them -

- (1) A Memorandum on the German Financial Effort for Re-armament (C.P. 148 (39));
- (2) A Memorandum on the Financial Position (C.P. 149 (39)).

FR 39(39)/2.

In view of the special need for secrecy, copies of these two Memoranda were handed in by Ministers on the conclusion of the discussion. For the same reason, a note of the discussion is not circulated, but a single copy is retained in the Secretary's Standard File of Cabinet Conclusions.

Richmond Terrace, S.W.1.

5th July, 1939.

THE FINANCIAL SITUATION.

(Previous Reference: Cabinet 29 (39), Conclusion 3.)

FR 39(39)12.

The Cabinet had before them -

- (1) A Memorandum on the German Financial Effort for Rearmament (C.P. 148 (39));
- (2) A Memorandum on the Financial Position (C.P. 149 (39)).

THE CHANCELLOR OF THE EXCHEQUER dealt first with the Memorandum on the Financial Situation (C.P. 149 (39)). In this Paper an attempt had been made to bring together a number of considerations of the utmost importance and of very great secrecy. He suggested that, in the circumstances, these two Cabinet Papers should be handed in on the conclusion of the Meeting.

This course was agreed to.

THE CHANCELLOR OF THE EXCHEQUER said that the contents of this Paper had been discussed with those of his colleagues who were associated with him in considering our financial position. While his colleagues had not approved every sentence in this Memorandum, the general line had been approved by them all.

The Chancellor then dealt with the first section of his Paper, headed "The War Chest", which represented our staying-power in war. There were four possible sources from which we might hope to pay for and acquire goods which we should need to import from overseas in the event of war, namely, -

- (1) Our export trade;
- (2) Stocks of gold;
- (3) Foreign securities owned by British subjects which the Government could acquire in order to increase our purchasing power in the United States;
- (4) Loans abroad.

As regards exports, in 1914 we had had a substantial favourable balance of trade, when invisible exports were taken into account. Although

we should take steps to stimulate exports in time of war, it did not look as though we could count on balance on any considerable source of strength under this head.

As regards gold stocks, the position was set out in paragraphs 4 to 9 of C.P. 149 (39). The Chancellor drew particular attention to the fact that the sterling balances held in London by countries of the sterling bloc were estimated to be falling at the rate of some £80 millions a year.

As regards paragraph 10, he understood the view of the President of the Board of Trade to be that the diversion of activities from peaceful enterprise to war preparation tended, on the whole, to lead to a decline of exports, but that there were certain countervailing factors.

Turning to the paragraphs dealing with the measures taken to protect the exchange, the Chancellor said that his colleagues would no doubt ask whether if the level of the £ was allowed to drop, we should put a stop to the loss of gold which was taking place. The answer to this was that it was held that it was essential to maintain the level of the £ to our utmost ability. Any further substantial drop in the value of the £, which had already dropped to \$4.68, would have very serious consequences for the United States of America. If we allowed the value of the £ to drop substantially, such a step would be likely to be resented by the United States of America, who might well take corresponding measures to change the relation between the Dollar and gold, which would nullify our action in devaluing the pound.

As regards foreign securities which the Government could requisition, the position as stated in paragraph 25 was that we could, by requisitioning,

obtain some £200 millions of foreign securities which we could hope to sell, but no more.

The view was expressed by certain Ministers that this figure was far below the total of British-held foreign securities.

THE CHANCELLOR OF THE EXCHEQUER said that there were, no doubt, other assets in foreign countries held by British subjects, but the view of the experts was that it would not be possible to realise such holdings to any appreciable extent.

The fourth factor in our war chest was represented by foreign borrowings. In the last War we had borrowed £250 millions from private investors abroad, which had been repaid; but the sums borrowed from the United States Government had not been repaid, and the position under the Johnson Act was that we could not borrow in the United States to-day, either privately or from the Government.

THE PRESIDENT OF THE BOARD OF TRADE asked whether it was not the fact that in the last War we lent very large sums of money to Russia and Italy. Was it not a fair presumption that demands from our allies in the next war for financial assistance would be less than in the last War?

THE CHANCELLOR OF THE EXCHEQUER said that it was not possible to frame any estimate of the rate at which the resources of our war chest might be drawn on in the event of war. The figure given in paragraph 30, which was a very imperfect guide, was the best indication which could be given.

The Chancellor said that the broad upshot of this part of the Memorandum was that we should realise that we were steadily reducing our war chest. It was impossible to say when war might break out. If it should break out some years hence, it was important

that those who were responsible for policy should realise that our financial strength was then likely to be much weaker than it was to-day.

THE CHANCELLOR OF THE EXCHEQUER then turned to the second section of the paper - Money for Defence. On the whole, he thought that this section was too favourably stated. He drew attention to the fact that, whereas in February of this year the estimate for defence expenditure had been £580 millions, this figure had risen in April to £630 millions and now to £750 millions. If £750 millions was to be spent on defence in 1939, he thought that the figures given for 1940 and 1941 might well prove to be under the mark, since up to the present it had not been thought that we should reach the peak of defence expenditure in the current financial year.

Further, the figures in these paragraphs assumed that no further major increase of defence expenditure was authorised. It also assumed that no foreign loans were granted.

The Chancellor drew attention to the figures in paragraph 33 which set out the balance which would have to be found for defence expenditure, after making allowance for defence expenditure which could be met from revenue on the basis of existing taxation. How were these vast sums to be found? It was also to be borne in mind that in the current year we should be helped by a circumstance which would not occur again, namely that owing to the loss of gold the Exchange Equalisation Account had available £150 millions of sterling which had been used to reduce the volume of Treasury Bills.

One course would be to have an Autumn Budget with large increases in taxation. In any event, however, heavy increases in the ensuing year seemed inevitable.

Another possible course was that the banks should be instructed to allow overdrafts to their

customers on condition that these overdrafts would be used for investment in Government loans. This, of course, would result in an increase in the amount of money in circulation and inflation, which would give rise to an increase in prices, which would be a grave matter. Clearly this course should not be resorted to until absolutely necessary.

The Chancellor then drew attention to the salient points in paragraphs 36-41. The statement in paragraph 41 that the normal cost of maintenance seemed likely to require some £450 millions - a figure unattainable on the present scale of taxation - was perhaps the most depressing of all. He felt, however, that for the time being it was a mistake to attempt to look too far ahead.

The Chancellor of the Exchequer then referred to the main points in the third section of the paper head - Conclusions. He thought that paragraph 44 should be amended by the insertion after 'avoided' in line 2 of the words "to any marked extent". Paragraph 44 pointed to the conclusion that we ought to consider something in the nature of a new ration for defence expenditure. As regards paragraph 46 he was not sure whether it was possible to provide estimates of the extra strain on the exchanges involved in substantial new expenditures, but such estimates would be useful if they could be provided. Paragraph 47 represented the extension of a plan which had already been carried out successfully on a small scale.

The Chancellor of the Exchequer then turned to the paper on the German Financial Effort for Rearmament (C.P. 148 (39)). His broad reflection on this paper was that, whatever method Germany may have relied on in the past, she had now come to rely on immensely heavy taxation of the working classes, coupled with a far lower rate of expenditure on the social services. This was brought out by the table in paragraph 16. As regards civil expenditure, Germany with a population of 90 millions spent less than we spent with a population of 50 millions. Broadly, while Germany had in the past relied largely on borrowing and less on taxation, she was now moving into the position in which she was relying less on borrowing and more on taxation.

The Chancellor said that he thought it would be a convenience if his colleagues were to have an opportunity of putting questions to Sir Richard Hopkins.

This course was agreed to.

(Sir Richard Hopkins, Second Secretary to the Treasury, then entered the Meeting.)

With reference to paragraph 34 of C.P. 149(39) SIR RICHARD HOPKINS explained that the reason why we had been able to borrow an additional £150 millions on Treasury Bills in 1939 but could not do so in future years was that we could not contemplate a further loss of gold in large quantities without a determined effort to check it. Of course if gold continued to be lost, to that extent we should be able to borrow additional sums by Treasury Bills with the sterling which would become available in the Exchange Equalisation Account. Broadly speaking there were two ways of approaching the problem; one was by attempting to reach agreement with the United States of America on devaluation; the other was by measures of control including measures to limit the import of commodities. In reply to the Home Secretary he said that the Treasury saw their way clear to continue until the late Autumn, at least, without the adoption of special measures. Indeed, he thought that it would be dangerous to adopt such measures until a stage of full employment had been reached, since such action would be a shock to confidence and would be regarded as a deflatory measure.

THE SECRETARY OF STATE FOR WAR asked Sir Richard Hopkins what were his views on the natural level of sterling, and whether it was fair to say that we were weakening our position by not allowing the natural level to operate.

SIR RICHARD HOPKINS said that in the opinion of some the level of sterling was rather too high. Any difference of opinion on this matter however related to a relatively small margin, say \$4.55 to \$4.68, and this would have but little effect on the gold losses. An attempt to stop gold losses by a reduction in the value of sterling would rather involve a devaluation of the pound to say \$4.20. Any measure of devaluation would, for the time being, have the effect of increasing exports and decreasing imports. It must be remembered, however, that any large modification in the exchange level would have a disturbing effect and would not be effective if other countries took retaliatory measures. Further a number of countries in the sterling bloc banked in London and would, it could be assumed, automatically follow sterling. There was also the question whether the United States of America would automatically follow suit.

THE SECRETARY OF STATE FOR WAR asked whether it was true that the position in regard to the export trade would be improved if the level of sterling was allowed to drop.

SIR RICHARD HOPKINS said that if there was a substantial fall in the sterling dollar exchange there would certainly be beneficial effects in regard to our trade with the United States and South American countries for the time being.

He agreed however with an observation by the President of the Board of Trade that the effect of devaluation of sterling in 1931 had lasted for a very short time. On that occasion it had become evident that sterling had been stronger than other currencies and the result of devaluation of sterling had been, broadly speaking, not a rise in sterling prices but a drop in other prices. He agreed with the Lord Privy Seal that there was no evidence to show that a drop in the exchange rates had more than a transitory effect. He also agreed with the Home Secretary that the effect was the more likely to be transient here because of the strength of organised labour which had the effect of making wages respond very quickly to changes in the prices of commodities.

THE SECRETARY OF STATE FOR AIR asked Sir Richard Hopkins whether his view was that we were not in a position to fight a long war.

SIR RICHARD HOPKINS said that the situation, undoubtedly grew more difficult with every month that passed. If war should break out in the near future, we should have in our war chest the existing gold stock less those foreign balances which would be removed. If, however, war occurred say a year hence those stocks would have been diminished by the drain in the intervening year. So long as we continued on the present course, our financial position was being weakened. The adverse balance of trade

resulted in a steady loss. This loss would be increased if we stimulated the production of armament goods which involved imports of raw materials.

THE SECRETARY OF STATE FOR AIR said that he had understood that it was the fundamental feature of our policy that we should conserve our strength for a long war, and he asked Sir Richard Hopkins whether that strength had gone.

SIR RICHARD HOPKINS said that this was not his view, but the Memorandum drew attention to very serious matters which must be borne in mind.

THE SECRETARY OF STATE FOR AIR asked whether we were in a worse position to fight a long war than in 1914.

SIR RICHARD HOPKINS said that this must be the case, subject to the question whether the United States of America was prepared to help us with finance.

THE PRESIDENT OF THE BOARD OF TRADE asked whether the United States were in a better position to finance us than in 1916.

SIR RICHARD HOPKINS said that the United States of America was a country of immense wealth. He did not think that their vast gold stocks would be of much help to them in financing us in war. The primary need would be that they should give us a share of their production without our paying for it. He agreed that the production of gold from South Africa could be increased, but South African gold belonged to South Africa and we should

have in effect to pay for it, either by exports to South Africa or by a loan from that country.

THE SECRETARY OF STATE FOR WAR drew attention to a statement in paragraph 6 of the introductory section of C.P. 148(39) which referred to the self-sufficiency of Germany. He contrasted with this a paper prepared by the Industrial Intelligence Centre which reached the conclusion that Germany could not last out for more than a year of war. He also referred to a paper which the Director of the Industrial Intelligence Centre had read to the Imperial Defence College which indicated that Germany would have to produce at seven times her existing rate if she was to maintain 100 divisions in the field.

SIR RICHARD HOPKINS said that he was not qualified to speak on the capacity of Germany to wage a world war; no doubt the views in the paper expressed by the Director of the Industrial Intelligence Centre did not purport to be more than estimates. He did not think that our war plans were prepared on the assumption that war could not in any case last for more than a year. The important point was, he thought, that for whatever period the war lasted, whether a year or longer, we should have to continue to import food and raw materials. Germany, on the other hand, had not got command of the seas and could not expect to import goods except from adjacent countries. Her plans had therefore been drawn on the basis of self-sufficiency.

THE MINISTER OF LABOUR asked whether the logic of this argument was not that we should make every acre of this country as productive as possible?

SIR RICHARD HOPKINS said that no doubt this process could be carried to a certain further stage with reasonable economy. He thought, however, that to apply our resources to the uneconomic development of the agricultural capacity of this country would probably involve an even greater strain on our resources than dependence on imports. It seemed to him that the right course was that we should seek to reserve a reasonable part of our foreign exchange resources in case we were in a tight corner. He also thought that we should consider every possible method of forcing the export trade in time of war.

THE PRIME MINISTER said that the point of paragraph 6 in the Introductory Section (C.P.-148 (39)) was that Germany relied on the policy of stocks or self-sufficiency.

SIR RICHARD HOPKINS agreed. If at any time Germany was short of a particular commodity and had to buy from countries overseas, her lack of gold would be the determining factor.

THE SECRETARY OF STATE FOR WAR said that these papers held out a dismal prospect for this country but not for Germany. Thus paragraph 19 of C.P. 148 (39) appeared to indicate that Germany could keep up her expenditure on armaments indefinitely. In this connection the Secretary of State for War drew attention to paragraph 5, on page 2 of C.P. 148 (39). He asked whether it was in fact the case that Germany was in no way relaxing her efforts and that she would keep up expenditure on armaments indefinitely.

SIR RICHARD HOPKINS said that so far as concerned internal finance, he thought that this seemed to be the case. So far as concerned obtaining necessities from abroad, there was a great difference between the position of this country and that of Germany. Germany was largely self-supporting in food. A commodity such as rubber was now produced in Germany by synthetic processes, though at great cost, thereby limiting the need for imports from abroad. So far as concerned overseas finance, Germany was bankrupt and the position was kept going by very severe controls which limited the imports of what we should regard as necessary commodities.

THE SECRETARY OF STATE FOR AIR asked whether it was a fact that Germany had spent between £3,000 and £4,000 millions on armaments in the last six years without starving her population.

SIR RICHARD HOPKINS said that this was broadly true. It had been done by lowering the standard of living.

THE SECRETARY OF STATE FOR DOMINION AFFAIRS said that German workers had good houses and sanitation and other services. Was their standard of living really so low?

SIR RICHARD HOPKINS said that the purchasing power of wage earners in this country was greater. In this country wages had risen as compared with 1929, but the position of German wage earners was much below the 1929 level.

THE SECRETARY OF STATE FOR DOMINION AFFAIRS thought that the position was that the German

worker worked harder than the worker in this country, and went short of amenities.

THE PRESIDENT OF THE BOARD OF TRADE drew attention to a report which had just been received from the Commercial Attache in Berlin, who expressed the view that the last few weeks showed an increasing strain on the whole German system. He also drew attention to the almost complete absence of ordinary consumption goods. The German worker could not spend his money on radios, clothes or furniture. He could only spend his money on beer, food and tobacco or invest it.

THE SECRETARY OF STATE FOR AIR asked whether a financial breakdown in Germany could be regarded as either inevitable or indeed likely.

SIR RICHARD HOPKINS saw no reason to anticipate a breakdown, at any rate within an early period of time. The ease with which the German financial situation had been coped with was, he thought, due to several causes. In the first years of the Nazi regime it was possible to raise large sums of money by borrowing, without inflationary effects, since the country had been in a deep depression and unemployment had been rife. Borrowing had, however, been rapidly reduced and taxation increased. So long as the present heavy rates of taxation were borne without a mutiny, this side of the position could be regarded as safe. The rate of borrowing in Germany was still very high and as the community, was now fully employed it must in the main be inflationary in character. It was uncertain how far borrowing could continue at the present rate.

[At this point the SECRETARY OF STATE FOR SCOTLAND left the Meeting.]

THE PRESIDENT OF THE BOARD OF TRADE asked whether Germany ran greater risk of industrial than of financial breakdown. She had already reached the limit of increasing production so far as unemployment was concerned. A certain amount had been done to speed up production, but the limits of increase in that direction had already been reached. Was it not possible that a fall in industrial production might bring about a financial breakdown?

SIR RICHARD HOPKINS said that he saw no prospect of such a drop in industrial production in Germany as would bring about a financial breakdown.

THE SECRETARY OF STATE FOR AIR said that Sir Richard had said that Germany was spending more than we were spending on armaments, that there was a prospect that Germany could fight a war as long as we could, and that none of the remedies proposed seemed likely to see us through a life-and-death struggle. Was it not necessary that we should consider whether we should do more than model ourselves on German methods?

SIR RICHARD HOPKINS referred to the measures indicated in C.P.-149 (39), particularly paragraphs 36 and 40.

In reply to the Secretary of State for Dominion Affairs he agreed that some of the measures there proposed should not be taken until all the absorbable unemployed had been absorbed. He thought that we should reach a full measure of employment (after allowing for those passing from one job to another, and for the "hard core" of unemployed) in a fairly short time, at the present rate of progress.

THE SECRETARY OF STATE FOR WAR said that C.P.-149 (39) seemed to indicate two alternative courses: that we should copy Germany's taxation, or that we should

adopt the measures of control therein indicated. Possibly both these courses should be adopted. He noted that the various methods of control were being studied, and he assumed that before the Cabinet was invited to reach any conclusions they would be informed of the result of that study.

SIR RICHARD HOPKINS said that the combination of courses suggested in C.P.-149 (39) was put forward as a line of action which it might well be necessary to adopt in order to avoid a financial breakdown in course of time. The study was directed to the practical measures which would have to be taken; as, for example, the statutory and administrative form which these measures would take.

THE SECRETARY OF STATE FOR AIR asked whether, if the measures set out in paragraphs 36 and 40 were adopted, we should be in a position to meet Germany's expenditure on armaments?

SIR RICHARD HOPKINS said that if these steps were adopted we should be in a far stronger position than we were today. He was assuming, of course, that the country could be persuaded of the need for these measures. This was not a matter on which he could express an opinion.

THE SECRETARY OF STATE FOR WAR drew attention to paragraph 35, which appeared to indicate a halt in expenditure on armaments.

THE MINISTER FOR CO-ORDINATION OF DEFENCE referred to paragraph 6 of the Introductory Section of C.P.-148 (39), where it was stated that Germany could not expect to import goods from overseas as in war. He said that in the last war Germany had imported large quantities of goods from Scandinavia, and would be able to do so again.

SIR RICHARD HOPKINS said that it had not been within his knowledge that Germany had been able to secure a large volume of imports in the last War. Any large volume of German imports in war would pro tanto modify the argument in the paragraph referred to.

THE SECRETARY OF STATE FOR FOREIGN AFFAIRS suggested that the large volume of German imports in the last war had been due in part to the fact that we had been slow in imposing measures of rationing.

THE MINISTER FOR CO-ORDINATION OF DEFENCE asked whether it was not the fact that the present heavy rate of expenditure on armaments to a considerable extent foreshadowed expenditure which in the last War had taken place in the first two years of the War? There was also the consideration that we might not have the same demands of our allies upon us for financial help. Was it not therefore possible that the demands upon our war chest in the next war would not be so great as in the last War?

SIR RICHARD HOPKINS said that an attempt had been made to get some estimate from the Departments concerned of the volume of imports likely to be required in war-time, but the attempt had been given up as impracticable.

He thought, however, that it must be assumed that war, as we now knew it, would be gigantically expensive in material, and that, whatever stores and reserves we might accumulate in time of peace, we must expect munitions to be produced at the highest practicable rate, which would mean that we should be largely dependent on imports of raw materials.

THE MINISTER FOR CO-ORDINATION OF DEFENCE said that we had not decided to raise an Army on the scale of Lord Kitchener's Army, and that the German Navy to-day was not as big as the German Navy in 1914.

SIR RICHARD HOPKINS agreed that these factors were important. On the other hand, it was impossible to present a complete picture of what we should be able to do in war by way of export trade. There might be great confusion in the world markets, and our ships might suffer severely from air attack on our ports.

It might be doubted whether we should in fact be able to export goods in adequate quantities to other countries as well as to produce what we ourselves required.

THE SECRETARY OF STATE FOR AIR thought that we might well be taking too gloomy a view of the position. He referred to a statement made by Sir John (afterwards Lord) Bradbury, in 1915, to the effect that further borrowing here would only be possible at the price of such an inflation of credit in relation to available commodities as would finally upset the balance of exchange and seriously impair our power to purchase either munitions or foodstuffs in America; and to various statements made by Mr. McKenna and Mr. J.M. Keynes in 1915, which had been falsified by the event. Was it not possible that the Treasury were again being too dismal on this occasion?

SIR RICHARD HOPKINS said that we now started with knowledge of the extent to which distressed economic systems had in fact been able to endure for a number of years.

THE SECRETARY OF STATE FOR FOREIGN AFFAIRS said that he rather shared the view that the general effect of these Papers might be to give too gloomy a view. All things were comparative. If our position was difficult, the position of Germany was very likely to be even more difficult in regard to the conduct of a long war. If, notwithstanding all her efforts, Germany was unable to make herself self-sufficient, that militated

against the theory of a long war. If this view was well founded, we should not exclude the possibility that our maximum effort would be well applied if we assumed the prospect of a reasonably short war. Even if this assumption should prove to be wrong and the war should last longer than we anticipated, it would be reasonably safe to assume that when the war had continued for some time the attitude of the United States would be sufficiently favourable to us to enable us to win the war.

SIR RICHARD HOPKINS said that if we assumed a short war, many of the apprehensions expressed in the first part of the Memorandum fell to the ground. He had always understood, however, that we could not proceed on the assumption of a short war, nor could we assume that the United States would be willing to give us unlimited financial resources in a long war.

Discussion then turned on the second section of C.P. 149 (39) - Money for Defence.

In reply to the Lord Privy Seal, SIR RICHARD said that from the point of view of our internal economy, it was impossible to continue to proceed on the existing basis. It was certain that, even if it was not necessary to introduce the machinery of control set out in paragraph 40 in peace time, it would be required very soon in war.

THE PRESIDENT OF THE BOARD OF TRADE made the point that at the present time we were being subjected to a war strain in times of peace and were trying to maintain the position by peace methods.

THE CHANCELLOR OF THE EXCHEQUER agreed that that was the immediate moral to be drawn from this part of the paper. It was, of course, possible to do many things in war which could not be done in time of peace. He also emphasised that the second part of the paper dealt,

not with a hypothetical issue but with the actual situation which faced us. It was clear that before long we should reach a position when we could not carry on with ordinary methods and supplementary methods would have to be employed.

THE SECRETARY OF STATE FOR AIR said he assumed that the Chancellor was not advocating any relaxation of the measures of defence which had been approved by the House of Commons.

THE CHANCELLOR OF THE EXCHEQUER agreed, but said that the point might well be reached when the multiplication of effort in a number of directions did not increase the strength of our position.

THE SECRETARY OF STATE FOR WAR thought that the acceptance of the sacrifices set out in this paper would have moral effect which would act as a powerful deterrent, by showing our determination.

THE CHANCELLOR OF THE EXCHEQUER added that the conclusion recorded in paragraph 40 had been reached on the basis of existing estimates of expenditure which seemed likely to be exceeded.

THE MINISTER OF LABOUR referring to paragraph 40 said that he regarded the control of prices as essential and he asked why the Memorandum spoke of "possibly also control of prices".

SIR RICHARD HOPKINS explained that the matter had been expressed in this way for two reasons: first, that this was a matter which was rather more in the sphere of the President of the Board of Trade than of the Chancellor of the Exchequer; second, that he believed that control of prices would come somewhat later in time than the other methods of control suggested.

THE PRESIDENT OF THE BOARD OF TRADE said that whatever measures we adopted, it was clear that the strain on our financial strength was increasing, and that

the point would ultimately come when we should be unable to carry on a long war. There would, therefore, come a moment which, on a balance of our financial strength and our strength in armaments was the best time for war to break out. It might be desirable to consider whether at such a period we should apply strong pressure to Germany to relax the international tension.

THE LORD CHANCELLOR, referring to paragraph 40, said that he thought that a measure which led to the stoppage of housebuilding or of the setting up of new industries would be a great shock to the public and he was not satisfied that such a measure would really assist our armament programme or our financial strength.

SIR RICHARD HOPKINS said that the purpose of such a measure would be to secure that money which would otherwise be spent in, say, building new houses was invested in Government loans and used to meet the cost of armaments. This was what was being done in Germany.

Reference was made to paragraph 25 of C.P. 149 (39) in regard to the sale of foreign securities abroad. Sir Richard Hopkins was asked whether the figure of £200 millions of foreign securities, which we could requisition and sell, represented a maximum.

SIR RICHARD said that he thought it was. There were, no doubt, large holdings of sterling securities in undertakings which operated abroad, but the question remained whether it would be possible to find sellers for such securities on any substantial scale. The view generally held was that there would be the greatest difficulty in selling such securities in war.

THE LORD PRIVY SEAL asked whether it would be possible to borrow against such securities.

SIR RICHARD HOPKINS said that the only likely lender was the United States Government. Even if that

Government was prepared to accept such securities as security for a loan, they would only be entitled to obtain the proceeds of the security in sterling. The exchange difficulty - which was the pressing ground of non-payment of interest on the existing war debt - would then remain.

Reference was made to the suggestion in paragraph 47 that the process of acquiring stores of the various essential commodities should be carried further at the present time (in spite of the immediate gold losses which that course involved) in order to avoid (a) enhanced prices and (b) difficulty of carriage in war.

THE PRESIDENT OF THE BOARD OF TRADE said that this matter had been under discussion since the Spring and he rather thought that the Treasury had changed their view, and were not now disposed to agree to these transactions on any large scale.

THE MINISTER WITHOUT PORTFOLIO said that a Paper would be coming before the Committee of Imperial Defence within a few days dealing with such purchases. He was convinced that this course was the right one.

SIR RICHARD HOPKINS said that he had not seen this paper but for his part would be prepared to recommend acceptance of such purchases on a reasonable scale.

THE PRIME MINISTER said that he thought that these Memoranda had been circulated mainly for purposes of information and in order that the considerations set out therein might be borne in mind in framing future policy. He assumed that the Chancellor did not ask for any specific conclusions to be recorded.

THE CHANCELLOR agreed.

The Cabinet -

- (1) Took note of the analysis of the German Financial Effort for Rearmament, set out in C.P. 148 (39).
- (2) Took note of the analysis of the present Financial Situation set out in C.P. 149 (39), and in particular of those passages in the Memorandum which set out the measures which it was contemplated would prove necessary in order to make available the money required for the Defence Programmes.

Richmond Terrace, S.W.1.

5th July, 1939.

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C.P. 148 (39).

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CABINET.

THE FINANCIAL SITUATION

THE GERMAN FINANCIAL EFFORT FOR REARMAMENT

Note by the Chancellor of the Exchequer.

I CIRCULATE for the information of my colleagues a Memorandum prepared in the Treasury on the German financial effort for rearmament

(Initialled) J S.

Treasury Chambers, S.W 1,
July 8, 1939

I.—Introductory

THE main part of this note consists of an analysis of the present financial effort of Germany as compared with that of this country

2 As, however, the question is often asked in general terms why this country cannot at all times do what Germany does, it may be well to make one or two general observations on that subject

3 The present régime in Germany started in a period of great depression with quite a small national debt, and was in a position to use inflationary methods on a very large scale while merely taking up the slack in employment. The country is now fully employed and as much of their borrowing has been and remains inflationary, they may be approaching the end of these resources and the advantage in this one respect may lie in future on our side

4 The population is docile and ready to accept regulation. A complete system of regimentation has been gradually built up with typical German industry until it permeates the whole economic machine. The system is said to be based on discipline, but this discipline is enforced by the power of the party agents and by the fear of the concentration camp.

5 Germany can and does impose upon the masses of the people much heavier taxation than has been attempted in this country

6 As Germany cannot expect in war to import from overseas, the policy has been to acquire great stocks of imported necessities, to produce at home substitutes for particular types of essential imports, though involving great

[19517]

B

economical waste and to acquire power over adjacent territories which can supply German needs. The question of the means of payment for overseas imports in war—an ever present anxiety in our case—scarcely arises in Germany. We cannot be self-supporting even if we wish to.

II *Note on the present financial effort of Germany and this country*

1 If not quite hopeless it would be an extremely difficult task to set out in any clear way the comparison between the financial effort made by Germany and that of this country. We should not really be comparing like with like, since there are profound differences between the economic systems of the two countries. The German economic system is determined by her internal political and social system, which is entirely different from ours.

2 Apart from this a great deal of the statistics necessary to make a comparison are not published in Germany and so far as figures do get published in that country their propaganda aspect has no doubt been well considered in advance.

3 A third type of difficulty lies in the fact that the two currencies are not comparable. Sterling is on a one value whereas the different kinds of marks have all sorts of values. It is open to any writer who chooses to convert marks to £ at the official rate of 11.9 to the £. Another author might choose 20 to the £, and get all his figures different by nearly 70 per cent.

To estimate the equivalent of marks in sterling for the purpose of this memorandum we have the following index numbers of hourly wages:

	1929	Dec 1938
Great Britain (100 in 1924)	92.1	103.9
Germany (100 in 1928)	105.5	84.1

On the basis of 100 in 1929 the index numbers for December 1938 would therefore be for Great Britain 105.9 and for Germany 79.7. The German is to the British as 75.2 to 100. If the gold parity of 20.43 marks corresponded to monetary equilibrium in 1929 the appropriate figure now would be 15.34 marks. Alternative comparisons based on the movement of prices since 1929 would give higher figures. Such matters as the change in our fiscal system since 1929 tend to disturb all comparisons, and on the whole it is thought a fair rate for comparing incomes or taxes in the two countries would be 16 marks to £1. There is no real certainty about the figure but we do not know how to improve on it.

4 As regards unofficial estimates of the position in Germany the trouble is that there are so many of them and that they reach such conflicting results.

5 Dealing with the matter in general terms the position would appear to be as follows:—

There can be no doubt that Germany has been spending absolutely a larger sum and is still spending an absolutely larger sum on armaments than we are. This is what one would expect in view of the vastly greater size of her army. The fact that Germany has more money to spend so far must be due to one or more of the following causes:—

- (a) she raises more by taxation;
- (b) she spends less on civil government, leaving therefore a larger balance available for defence;
- (c) she borrows more for defence purposes.

No doubt all these things have been true in the past but broadly speaking the Treasury would be inclined as regards the present to attach little importance to the last two items and a great deal to the first.

6 Assuming indeed that we succeed in carrying out the borrowing programme contemplated for this year including that required to meet supplementary estimates it may well be that on the point of borrowing we shall be running ahead of Germany. As regards the cost of civil government it must be borne in mind that with roughly the same kind of total national income the German population is to ours as about 5 to 3. She is not barren of social services of which indeed she was largely the pioneer, but they are run on more economical lines than our own, and

in particular a much larger proportion of the cost is borne on the beneficiaries. In an administrative sense by no means get the reputation for economy and the authoritarian nature of the Government rather implies an expensive administration. It is while not out of the matter a government may be cheaper than ours per head it is *prima facie* likely that a total it will be much cheaper except as regards debt charges, where after six years of most lavish borrowing the annual charge cannot yet be much over £100 millions a year.

7. It is would leave the difference in the product of taxation as the sole or main factor explaining the ability of Germany to spend larger sums in armaments than we do. There can be no doubt whatever since the information comes from all quarters that in fact German taxation is higher than ours in many respects. They have for instance a 40 per cent tax on the profits of companies on top of the ordinary income tax. Important also is the greater power they have of enforcing taxation in the form of a subservient judiciary and the other methods of the concentration camp for offenders.

8. In comparing the yield of taxation in the two countries however there is this to be borne in mind. Germany is really in this sphere as it offers a year or so ahead of us. She has already achieved the almost complete abolition of unemployment whereas we are still a long way from that state of affairs. In other words while the yield of the taxation system in Germany may be reaching its peak it is certain that ours will not reach its peak for another year.

9. If it be asked what price Germany has paid for her success in this field the answer is to be found in three or four directions.

- (a) The standard of living is much lower in Germany as compared with 1920. German wage rates appear to be down by some 20 per cent., whereas in our case wage rates are up by 6 per cent. since the same date. That is not to say that the Nazis have actually reduced wage rates, a statement which it would certainly be impossible to prove. The fact is that they seized power at a time of deep depression, after wage rates had been brought very low, and they have prevented any considerable recovery in those rates. The destruction of the Trade Union machinery for securing wage increases would probably have been effective by itself even without the direct State regulation of wages.
- (b) The cost of living in Germany has nominally fallen but there has undoubtedly been a fall in real wages, and the tax burden on the working classes is now extremely heavy. Likewise the standard of living of the middle and upper classes has been greatly depressed by the extreme weight of taxation.
- (c) In order to secure more money for defence other parts of the German economy e.g. the railways have been allowed to run down considerably in efficiency owing to their inability to obtain funds for maintaining their equipment properly. A similar state of things has not occurred yet in this country.

10. There is also of course the question how long Germany can continue to devote so much energy to armaments. Down to the time of Dr. Schacht's disappearance Germany was pursuing a general economic policy which in certain respects could be qualified as rather conservative. This appears to longer to be true. The recently published device for paying for Government purchases in paper carrying tax and privileges in future years suggests an attempt to eat their own words. It is given that it is not clear that this is yet in a sense what would result in marked difficulties in raising taxes later on.

11. The above is the broad picture. So far as it is possible to do this in the form of statistics the attempt is made in the paragraphs which follow.

12. There are two major difficulties in giving actual figures viz. (a) no detailed figures for State expenditure whether on armaments or for civil purposes have been published for several years, (b) only very incomplete figures for State borrowing are available.

13. In 1938-39 the Reich received tax revenue of 17,691 million RM (£1,106 millions) of which 2,000 million RM (£125 millions) was passed on to the States. State and local taxation amounted to 4,900 million RM (£306 millions)

Total taxation Reich, State and local was thus nearly 22,600 million RM* (£1,412 millions).

The expenditure by the States and local authorities was 6,900 million RM (£431 millions). What was the civil expenditure by the Reich in addition to the 2,000 million RM granted to the States? We only know that the corresponding items for 1934 amounted to 5,590 million RM (£349 millions). We do not know how that figure may have varied except that (1), the debt charge which was 500 million RM in 1934 must surely have risen to 1,500 million RM and (2) Austrian Civil expenditure has to be included. Perhaps the Reich Civil expenditure in 1938-39 was 7,500 million RM (£469 millions). Then total civil expenditure (Reich, States, local) was 14,400† million RM (£900 millions).

14 But we have also to allow for the fact that the contributions to the Unemployment Insurance were 1,600 million RM (£100 millions) in excess of the cost of unemployment relief. Still a surplus may appear later on in the form of State debt, but it is debt which does not have to be borrowed.

15 The amount available for defence from borrowing is entirely obscure. Balogh, basing himself on results to October, considers that it may have reached 11,000 million RM for the year (£688 millions). But some unknown part of this must have been borrowed for state financed investment (including partly the four year plan investments) roads, canals, public buildings, &c.

The increase in the disclosed internal debt in the year 1938-39 was 11,813 million RM (£738 millions) of which long term debt was 7,623 million RM (£477 millions). But we do not know how much of the long term debt was new money and how much was funding of short term debt previously issued the 'secret debt'. The Germans decided at the beginning of 1938 to issue no more special bills. One would naturally presume that in such conditions a good deal of the new long term debt was for funding i.e. for providing money to pay off bills as they matured. Now the statistics of bills of all classes held by German banks show no decline but an increase of 3,400 million RM between March 1938 and March 1939. A very considerable volume of special bills was however held outside the Banking system and there is nothing to show these were not redeemed out of long term borrowing.

On the whole the amount spent on defence out of borrowed money by Germany in 1938-39 is quite obscure. One is inclined to regard £500 millions (at 16 RM to the £) as the maximum. It may be a great deal lower. To add the figure £500 millions + £100 millions would allow for some funding and also for some of the borrowing having been for non defence purposes but it is all quite speculative.

16 We can now compare the German figures for 1938-39 with say our own Defence arrangements for 1939-40:—

	United Kingdom As proposed 1939-40. £m.	Germany As guessed for 1938-39 £m. (£= 16 RM.)
Revenue (national plus local) ..	1,152	1,413
Profit on Unemployment Insurance ..	...	100
Civil Expenditure (national plus local)	905	900
Available from Budget for defence	247	613
Borrowed for Defence	400‡	‡ 500 (± 100)
	647‡	1,113 (± 100)

17 The figure for the yield of national revenue is the best attested of the lot and if there is an error in the local revenue it would be balanced by a corresponding error in local expenditure. The figures seem to show that we are

* cf Balogh, International Affairs, March 1939, p. 232. He gives 22,000 million RM.

† R. makes civil expenditure in 1932 10,000 million RM after allowing for any RM spent on He carries the figure forward and makes it of 2,000 to 4,000 million RM for present of civil expenditure for long term borrowing He does not refer specifically to debt charges or Austria. Generally his figures seem far too low.

‡ It is a margin for supplementary estimates but a preliminary examination of the supplementaries threatened this July indicate a further great increase.

nothing of the sort at present. Later on we may have. For example, if the £30 millions a year more to invest.

The figure for German civil expenditure is more doubtful than that of taxation. If the £900 million figure is in error it is below the truth. It seems

The guess-work nature of the figure for German borrowing has been sufficiently brought out in paragraph 15 above.

programme.

19. It will be noticed that the above comparison is between the United recent speech by Herr Reinhardt runs as follows —

"Cost of Rearmament"

Secretary at the Ministry of Finance, implicitly replied to criticisms of the taxation system.

Herr Reinhardt said that the historic achievements of the Führer, securing and development of the vital rights of the Great German Reich were only possible with strong armed forces. It had been said that the rearmament should have been spread over a greater number of years. 'I believe that only a fool or an absolute enemy of the Reich would make this assertion.' Admittedly, the cost of rearmament would then have been less and the cost of the western fortifications would not have arisen at all. On the other hand, in all probability Germany would have had forced upon her last year a war which would have cost many times as much.

In answer to the question frequently asked, 'Where is all the money coming from?' Herr Reinhardt pointed to the 'Constantly increasing financial strength of the Reich'. Taxation revenue had risen from 6,600,000,000 marks in 1932 to 17,700,000,000 m. in 1938. In the current financial year it would probably rise to 22,000,000,000 m., and it would be of this year from the levy on Jewish fortunes.

The method previously followed of financing the State's needs by short or medium term loans, which were afterwards converted into long term loans, represented a charge on future tax revenue because the service and redemption of the debt had to be met from taxation. Many milliards more could

to close the capital market to private industry.

In principle that part of the extraordinary expenditure of the Reich which could not be met from taxation would in future be covered only by

in 1940 the issue of interest-bearing tax certificates on the same scale as in 1939."

4.3 milliards (£269 millions) over 1938-39 the implications are staggering. It is not so much that it gives them more to spend on armaments, because, as is obvious and as Reinhardt says, their *borrowing* must be coming down. But it means that they have over £330 millions a year for defence *without* borrowing against our £247 millions, and unless their Budget breaks down they can keep it up indefinitely. If the calculations are £100 millions or even £200 millions wrong an enormous disparity still remains between the United Kingdom and the German figures.

20 The following is an analysis of German tax revenue for the year 1938-39.—

						<i>Millions of Marks.</i>
Income tax —						
On wages	..	..	..	..	..	640
On salaries	..	..	..	..	..	1,451
Other	..	..	..	..	..	3,261
Corporation tax	..	..	..	..	..	2,408
Other direct and miscellaneous taxes	..	..	..	..	..	1,594
Turnover tax	..	..	..	..	..	3,357
Customs	..	..	..	..	..	1,818
Other taxes on consumption (including railway traffic tax)	..	..	..	..	..	8,162
Total						17,691

In the British tax system the proportion of income tax derived from wages is negligible. We may compare the whole British income tax and surtax with the German tax on incomes other than wages. The German tax on wages, together with the turnover tax, customs and taxes on consumption, may then be compared with our indirect taxes. The following comparison results —

<i>Germany (1938-39).</i>			<i>Great Britain (1938-39)</i>	
	<i>Millions of Marks</i>			<i>£ millions.</i>
Income tax (other than wages)	4,712	294.5	Income tax and surtax	898.4
Corporation tax	2,408	150.6	National Defence Contribution	21.9
Other direct taxes	1,594	99.6	Other direct taxes	135.6
	8,714	544.6		555.9
Customs	1,818	118.6	Customs	226.3
Consumption taxes	8,162	197.6	Excise	114.2
Turnover tax	3,357	209.8		
Income tax on wages	640	40.0		
	8,977	534.4		840.5
	17,691	1,105.6		896.4

The German figures are believed to include Austria but not the Sudetenland. The German national income for 1937 was estimated at 71 milliards (equivalent to £4,400 millions). Unfortunately, there is no reliable estimate of the British national income for comparison, perhaps it is £4,500 millions. The preliminary estimate of the German national income for 1938 is 77 milliards. With Austria the total is likely to be well above 80 milliards (£5,000 millions).

21 The most striking results of the above comparison of tax yields are (1) the very heavy burden on the working classes in Germany, (2) the heavy German corporation tax (40 per cent of company profits), and (3) the relatively modest yield of income tax and other direct taxes.

The turnover tax, it is true, falls not only on the working classes but on all incomes. But the same applies to customs and excise duties in both countries, and the income tax on wages in Germany is more definitely a working class impost than the indirect taxes in Great Britain. Local taxation in Germany has been estimated at 5 milliards (nearly £300 millions), and compares with about £210 millions in Great Britain. Contributions from employers and employed for

health and unemployment insurance, &c., amount in Germany to no less than 5,273 millions, or £330 millions (twelve months to June 1938). For Great Britain in 1936 they were only £110 millions, and are probably still under £120 millions.

III.—*German Imports.*

22 The Treasury were asked for a note about the recent increase in German imports as shown by the tables compiled by Sir George Schuster and recently published in the "Economist."

These tables were tables of volume, and the increase is largely explained by the lower cost of food and raw materials.

The following table shows the imports in certain years in millions of marks —

	Total Imports.	Raw materials and half finished goods.	Food and drink
1913	10,770	6,280	2,808
1929	13,447	7,205	3,823
1933	4,204	2,420	1,082
1937	5,468	3,295	1,485
1938	5,398	2,890	1,998

Imports of raw materials and half finished goods fell from over 7,000 million marks in 1929 to under 3,000 million marks in 1938. The world gold price index for 1938 is 45.4 per cent. of that for 1929. If that can be applied to German imports the 2,890 millions of marks of 1938 would buy as much as 6,360 millions in 1929.

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July 3, 1939*

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CABINET.**NOTE ON THE FINANCIAL SITUATION****I.—THE WAR CHEST**

THE recent development of events—particularly the growth of the Defence programme and the persistent demand for loans and credits from foreign countries—has added to the problem of finding money for defence a new anxiety as to our ability to defend the £ and to continue to purchase vital necessities from abroad, both in present conditions if they continue and, above all in war.

2 Ordinarily imports are paid for by exports or else by gold or the sale of foreign assets. When the balance of trade is adverse as it is now, both increased foreign purchases for defence and equally loans to foreign countries involve within a brief space a loss of gold.

3 The present policy is increasing the pressure on the exchange in three ways

Armaments made at home for ourselves involve the import of raw materials from abroad equal probably on average to 25 per cent to 30 per cent of the value of the orders, and in these times possibly more.

Armaments purchased from abroad absorb gold

Loans and credits to foreign countries, if expended on the purchase of goods in this country, involve imports on the average of 25 per cent to 30 per cent or more of the money so expended, if taken abroad in the long run they add in whole to our gold losses.

4 Fifteen months ago our gold stock was over £800 million. It looked imposing, but, in fact, gave a rather misleading appearance of strength. It had been accumulated in some considerable measure owing to the transfer to London of fugitive short money. In less than 15 months of international tension nearly 40 per cent of our gold stock has disappeared.

5 The reasons for our gold loss of over £300 million in 15 months (only part of the figures published) are as follows:—

6 The economic set-backs in 1937 profoundly disturbed world conditions, the effect being especially marked among the best customers of our export trade.

7 A great deal of fugitive French money has returned to France, to that extent our loss is France's gain.

8 The balance of our trade is adverse, but the essential point for sterling is the aggregate balance of trade of the sterling bloc which banks in London. It

is estimated that for a period of 18 months to December last the sterling balances held in London by countries of the sterling *bloc* were falling at the rate of some £80 million a year.

9. These economic factors leading to a depletion of our gold stocks have been reinforced by the effect of political conditions. A great deal of fugitive money in London has been transferred by foreigners to the United States or other supposedly safe countries, and probably there is a small trickle of British investments to the United States, though the amount is not significant.

10. War preparations have played a part and will play a much greater part in determining the fate of our gold reserves:—

Diversion of activities from peaceful enterprise to war preparation leads to a decline in exports, and the intensification of the defence plans leads to an increase in imports, especially of raw materials, but in some cases also of completed goods from the United States. War preparation has come to include the giving of loans or grants to foreign countries on a large scale.

11. The limit of commercial export credits has recently been increased from £50 millions to £75 millions, and the amount of the credits actually granted has increased very greatly in recent months. Sound short-term commercial credits certainly resulting in repayment in not more than two or three years are not so very harmful, but medium and long-term credits are harmful, particularly if repayment is uncertain.

Included in these credits are £10 millions for Russia, more than half of which is unspent, and £10 millions for Turkey, of which £2 millions is already being spent.

12. It is unfortunate that at a time when we shall clearly have to cut down capital expenditure in this country needed to maintain the standard of living we should have committed ourselves to finance capital expenditure for the development and industrialisation of other countries.

13. Apart from these commercial credits, there is a further £6 millions for Turkey, £4 millions net for Czecho-Slovakia, £5 millions for China, a probable £30 millions for India (Army re-equipment).

14. Existing commitments in respect of "political export credits" to various countries amount to £19 millions, plus interest, and suggestions from Government Departments for new promises under this head to cover the cases of Poland, New Zealand, Turkey, Roumania, &c., and to give a margin for further applications, bring the total to £60 millions, plus interest, which will appear in a Bill about to be introduced.

15. The Polish Government, in fact, asked for £60 millions; New Zealand is in difficulties and needs new money both for defence and for other purposes; Roumania and Turkey are both asking for more.

16. The following measures have been taken to protect the exchange. The value of sterling has been let down from 5 dollars to 4.68. The embargo on foreign issues has been greatly tightened up. A very large *bloc* of gold has been transferred from the Bank of England to the Exchange Equalisation Account for use in active defence. Sweeping measures to discourage and impede speculation have been taken.

17. Very little more could be done even with the most far-reaching powers. A further small depreciation of the £ would be ineffective; a large depreciation, even if it were on balance desirable, is not at present practical politics.

18. Up to the present the disadvantage of our gold loss has been largely political. It must discourage our friends and encourage the Axis Powers.

If it continues swiftly it will soon become also a serious economic anxiety even in peace. But the greatest anxiety is that it may gravely affect our staying power in war. Our gold stock, together with such assets as we may be able to sell or mortgage in wartime to countries overseas, constitutes our sole war chest.

19. The amount of our requirements of foreign exchange in a war of long duration defies calculation. We shall require food and raw materials and maybe armaments in great quantities. What exports we can sell, and to whom, to

offset the imports, is uncertain. It is uncertain, too, to what extent our allies will be financially dependent on us (though it is *prima facie* unlikely that Russia would require financing in a new war to the extent that she did in the Great War).

20. The only prudent conclusion is that we ought to preserve the largest war chest possible. To-day that chest contains some £200 million of foreign securities which we could hope to sell or mortgage, and £500 million of gold rapidly diminishing.

21. The contrast between this and our war-chest at the beginning of the Great War is as follows.

22. On the one hand our gold stock is for the present much in excess of that in 1914.

23. On the other hand, in 1914 by stopping foreign lending we could, other things being equal, improve our buying power by some £200 millions a year. To-day there is no foreign lending and our revenue account is £50 million a year to the bad.

24. In 1914 we recalled some £50 million short money invested abroad; to-day much short money invested in London can be withdrawn from us.

25. In the Great War we requisitioned and sold abroad some £200 million of foreign securities apart from private sales abroad which were probably considerable. To-day we can by requisitioning obtain £200 million of foreign securities and hope to sell these, but no more.

26. In the Great War we did not need to attempt to sell blocks of sterling securities. In the next war, though we could try to do so, the possibility of success on more than a very small scale is exceedingly doubtful.

27. As regards foreign borrowing in war, the contrast with our position in the Great War is as follows:—

28. In the Great War we borrowed £250 million from private investors abroad (mostly U.S.A.) all of which was repaid and we borrowed £840 million from the United States Government (not repaid). To-day under the Johnson Act we cannot borrow in the United States either privately or from the Government.

29. Nevertheless, unless, when the time comes the United States are prepared either to lend or to give us money as required, the prospects for a long war are becoming exceedingly grim.

30. It has already been pointed out that it is impossible to frame estimates of the rate at which our resources in gold and foreign securities might be drawn on in the event of war. At the rate, £20 million a month, at which we have been using gold, our reserves would barely last three years and considering the increased demands likely in war, this estimate of the period is very likely much too optimistic.

II.—MONEY FOR DEFENCE.

31. The Cabinet review of February, 1938, allotted for defence in 1939, 1940 and 1941, roughly £1,000 million.

This had grown by September 1938 to roughly £1,100 million.

Subsequent additions, for most but not all of which rough estimates have been given by the Defence Departments, may be put broadly at £1,000 million.

Present rough total for three years, £2,100 million.

32. A division between years may be guessed as follows:—

	£ million.					
1939	750
1940	700
1941	650

[The figure now estimated to be required in 1939 exceeds by £120 million the figure mentioned in the Budget speech in April.]

[19547]

33. On the basis of existing taxation, allowing on an optimistic basis for estimated increases of yield and some favourable factors affecting the capital account, the balance of expenditure to be found somehow may be guessed as follows:—

1939	...	...	...	...	...	£500 million or a little less
1940	...	...	...	...	...	£360 million
1941	...	...	...	...	...	£330 million or rather less

34. In 1939, but not in subsequent years, £150 million or thereabouts can be borrowed on Treasury Bills, leaving, say, £350 million to be borrowed on long or middle term.

35. The foregoing figures are far beyond anything that can be borrowed by ordinary means without inflation.

36. One remedy lies in increased taxation. The Cabinet note of April last on the growth of Civil Expenditure showed that between 1925 and 1938 the yield of increases in taxation amounting to £245 million enabled us to provide £153 million more for defence. In 1939 £24 million new taxes were added, but the additional amount for defence was lowered to £125 million.

Additional taxation, totalling on a full-year basis some £280 million, has been secured by—

- Increasing income tax and supertax by roughly 40 per cent.
- Increasing tobacco duty by 40 per cent.
- Increasing estate duties by roughly 20 per cent.
- New oil duty at 9d. a gallon.
- New tariff duties.
- Many minor changes, including, e.g., 25 per cent. increase on private motor duties and much heavier increases of duties on commercial vehicles.

37. There must be some limit to new increases of taxation in peace if any elasticity is to be left over for war, when the yield of many customs and excise duties will cease or greatly fall and collection of direct taxes may in the initial stages be greatly delayed.

38. Suppose by way of illustration that in the Budget of 1940 taxation is increased by £100 million (e.g., by a Budget of new taxes similar to the last Budget, plus 1s. extra on the income tax).

The requisite borrowing would then be—

- 1939: £500 million, of which £150 million would be by Treasury Bills and £350 million on long or middle term.
- 1940: £260 million.
- 1941: £230 million or rather less.

39. These figures, which take no account of concurrent requirements of money for loans to foreign countries (and equally take no account of Dominion and municipal borrowings), are up to, if not beyond—and in the case of the current year are certainly beyond—the limit of what can be borrowed out of savings by ordinary means.

40. In the course of time, therefore, and may be a short time, it is likely to be necessary to contemplate a variety of controls, especially—

- Prohibition of new issues.
- Control of advances by Banks.
- Control of advances by Building Societies.
- Control of Companies' dividends and investment of their reserves.
- Possibly also control of prices.

These matters are accordingly being studied at the present time.

41. It has so far been assumed that the programme would end in April 1942. There must at best be an overlap. Even when the normal cost of maintenance is reached, it is likely to require (including the service of the new debt) some £450 million per annum, a figure unattainable on anything resembling the present scale of taxation.

III.—CONCLUSIONS.

42. Apart from increased taxation, the following means of arresting the general deterioration suggest themselves :—

43. The primary need is to conserve our resources in gold and foreign exchange, which represent staying power in war.

44. Inflation, with the gold losses it would involve (apart from its other evils), must be avoided. Very heavy increases of taxation are in prospect, and in the course of time general controls are likely to become necessary and the standard of living must be directly or indirectly affected.

45. Purchases abroad of armaments must be avoided to the greatest extent possible. Further expenditure on armaments in this country cannot be undertaken without counting the cost in gold. Indeed, as there is a prospect of the continuance of the present armed peace, if not of the outbreak of war, finality of expenditure (unless for overmastering reasons) should now be declared.

46. If nevertheless substantial new expenditures are contemplated, the Cabinet should be provided not only with estimates of cost, but so far as possible with estimates of the extra strain involved upon the exchanges.

47. In any lengthy war there are types of food and of vital raw materials, the acquisition of which from overseas is essential to our continued existence. It is for consideration whether, bearing in mind the possible lack of means of foreign payment in war, the enhanced prices and the difficulty of carriage in war and the possible losses at sea, the process of acquiring stores of such essentials (now standing in the case of a variety of special minerals, &c., required for war at about six months' war requirements), where they are durable and capable of safe storage, should not be carried further in spite of the immediate gold losses which that course involves.

48. Loans to foreign countries, specially loans not to be expended in this country, must be restricted to the lowest possible limits. The point to be borne in mind here is that every new commitment of this character definitely reduces the period for which we shall be able to finance war.

*Treasury Chambers, S.W. 1,
July 3, 1939.*
